BRIEF IN SUPPORT OF THE PETITION

I.

THE OPINIONS OF THE COURTS BELOW

a. The District Court of the United States for the District of Minnesota, in which this cause originated filed an opinion which appears in the printed record at page 70.

b. The Circuit Court of Appeals for the Eighth Circuit filed an opinion on April 20, 1942, which appears in the printed record at page 82 and is reported in 127 F. (2) 440.

II.

JURISDICTION

The jurisdiction of this Court is invoked pursuant to Title 28, Judicial Code and Judiciary, Section 347, former Section 240, Judicial Code, amended.

III.

SPECIFICATIONS OF ERRORS

The Circuit Court of Appeals for the Eighth Circuit erred in affirming the order or judgment of the United States District Court for the District of Minnesota, which affirmed the order of the referee allowing the claim of the respondent.

IV.

STATEMENT OF THE CASE

Respondent filed a claim for $4,970.00, which included $20.00 as a balance on salary (R. 10). The referee disallowed the $20.00. Hence, there is no question of salary in issue. Petitioner objected to the allowance of the claim (R. 7). The evidence showed the bankrupt to be a Minnesota corporation with an authorized capital of $20,000.00, all paid in (R. 3). The charter limited debts to $10,000.00 (R. 11). The management and control of the corporation was in the same free and easy manner as in the case of a partnership or joint venture, and after 1925 under the complete domination and control of respondent and Rose. The by-laws provided for a board of directors of three, vested with control and management of the corporation (R. 11). No dividends were to be paid that would impair the capital (R. 12). Respondent, Rose, and Paulsen were re-elected directors to and including 1922 (R. 13-16). The first officers and those re-elected to and including 1922 were Rose, president, Paulsen, vice-president, and respondent, secretary and treasurer (R. 12-16). No stockholders' or directors' meetings were held from July 18, 1922, until July 19, 1938, when R. E. Morrissey became a director (R. 35-37). Morrissey was at all times inactive (R. 35). In 1925, Paulsen sold his capital stock to respondent, Rose, and Morrissey (R. 37), and by virtue of the by-laws ceased to be a director or officer (R. 12). While Rose was paid a regular wage for managing the business (R. 35), he also made unauthorized withdrawals at irregular intervals, including $3,030.00, after the capital was impaired (R. 18, 21). Of this sum, $2,020.00 was withdrawn during the time that respondent was contributing to the corporation. The unauthorized withdrawals were made by

checks signed by respondent. Hence, respondent was a party to such unauthorized withdrawals. Respondent kept the books of the corporation, had sole charge of its finances, signed all checks and at all times had complete knowledge of the finances, assets, business and affairs of the corporation (R. 39). Respondent's contributions were made as follows: $3,450.00 in 1935, $1,000.00 in 1936 and $500.00 February 25, 1937 (R. 10). These contributions were made at irregular intervals to prevent the bank account from being overdrawn (R. 23-27) and to save the business (R. 38). No arrangement as to repayment was made (R. 38-39). These contributions were made in the same manner a partner or joint venturer would contribute to the capital investment, as more fully appears from the account with respondent on the books of the corporation (R. 17-18). The total net profits for the years 1927 to 1931, inclusive, were $665.52. The total losses for the years 1932 to 1936, inclusive, were $8,750.75. On January 1, 1937, the capital had been impaired to the extent of $2,926.63, and the total debt, excluding respondent's claim was $6,280.14. If respondent's claim was a debt, the total indebtedness was $11,250.14, or $1,250.14 in excess of the debt limit fixed by the charter. The assets and liabilities, profit and loss, and gross sales for the years that the corporation was in business appears in tabulated form at page 21 of the printed record. The above facts give the situation on July 1, 1937. The debts of the general creditors were contracted after that date. Respondent made no contributions after that date. On that date, respondent owned one-third of the capital stock and his contribution of $4,950.00 to the capital investment. The respondent knew that although the capital had been impaired, that because of his contribution, the financial standing and reputation of the business in the community had not been impaired and that credit would be extended to the

business on that financial standing and reputation. While respondent was not willing to make further contributions, he did obtain credit from the general creditors for the business in which he was largely interested. Respondent knew from the past experience of the business, that, to say the least, there was little prospect that the business could be profitably continued. He also knew that if the business failed and he were to compete with the creditors whose debts were contracted after July 1, 1937, for the payment of his contribution, that such creditors could not be paid in full.

The referee, Walter H. Newton, allowed respondent's claim on April 9, 1940 (R. 47), because the corporation received and used the money (R. 46). A petition for review was filed April 15, 1940 (R. 53), claiming, among other errors, that the allowance of the claim and permitting it to participate in a dividend would be inequitable and a fraud upon creditors whose debts were, because of claimant's acts and conduct, contracted after July 1, 1937. The District Court, the Honorable Matthew M. Joyce sitting, affirmed the referee on December 31, 1940 (R. 70). The trustee filed a motion for a rehearing of this order on January 10, 1941 (R. 74), upon the ground that the Court had inadvertently overlooked the fact that over $9,000.00 of the indebtedness of the bankrupt was incurred after July 1, 1937, and that to permit the claimant to participate in a dividend with such creditors would be inequitable, if not fraudulent. The District Court entertained the motion for rehearing and denied it February 18, 1941 (R. 74). A notice of appeal was filed March 20, 1940 (R. 75), appealing from the order of December 31, 1940, as to which a motion for rehearing had been made and denied (R. 75). The Circuit Court of Appeals on April 20, 1942, by a divided court affirmed the lower court (R. 92). The majority opinion was written by the Honorable John B. Sanborn, Circuit Judge, and con-

curred in by the Honorable Gunnar H. Nordbye, District Judge of Minnesota (R. 82). The Honorable Harvey W. Johnsen, Circuit Judge, wrote a dissenting opinion (R. 88). A petition for rehearing was filed May 4, 1942 (R. 93), and denied May 11, 1942 (R. 105). The petition for rehearing called the Court's attention to the fact that it had inadvertently overlooked the issue between the respondent and the general creditors.

V.

ARGUMENT

1.

The Decision of the Lower Court Is Apparently in Conflict With the Decisions of This Court in That Its Failure to Subordinate the Contribution of Respondent to the Claims of the General Creditors Is Contrary to the Cardinal Principles of Equity Jurisprudence Applicable Between a Dominating and Controlling Stockholder and Director and Creditor, as Laid Down by This Court.

In *Pepper vs. Litton, supra*, this Court pointed out the cardinal principles of equity jurisprudence applicable to the disallowance or subordination of the claim of dominating officer or stockholder substantially as follows: That an officer or dominating stockholder is a fiduciary. That the standard of fiduciary obligation is designed to protect creditors as well as stockholders. That so-called loans or advances of dominating or controlling stockholder will be subordinated to the claims of other creditors and treated in effect as a capital contribution where the allowance would not be fair and equitable. That at times the debtor corporation will be treated as a part of the stockholder's own enterprise consistently with the course of conduct of the stockholder.

In the case at bar, respondent was a dominating and controlling stockholder and director. The business was conducted as though it were the enterprise of the respondent and Rose. To permit respondent to participate in a dividend with those creditors whose claims were contracted by him after July 1, 1937, considering the then condition of the corporate finances and respondent's interest in the business, would not be fair and equitable.

The lower court appears to have affirmed the District Court because the District Court held there was no unfairness in respondent's dealings with the corporation. The conduct of respondent in contracting debts after July 1, 1937, was not considered important. This is evidenced by the Court's language setting forth appellant's contentions (R. 85), which, however, omitted any reference to the contention relative to contracting debts after July 1, 1937. The Court said that appellant's contentions were not without merit (R. 85). The Court also said that it thought that the referee and the court below could have subordinated the claim of respondent to other creditors on a finding that his informal and irregular conduct of the affairs of the bankrupt had prejudiced their rights and was a violation of his duty toward them (R. 86). The Court's reason for not reversing the lower court appears in the following language taken from the printed record, page 86, to-wit:

> "We hesitate to say, however, that, under the evidence the court was compelled to subordinate Budge's claim to the claims of other creditors, believing as it did, that Budge was guilty of no fraud and of no unfairness in his dealings with the bankrupt."

2.

This Petitioner Has Not Had His Day in Court on the Issue Between the Respondent and the Creditors Whose Debts Were Contracted After July 1, 1937.

This reason is based on the failure of the referee, District Court and Appellate Court to consider that there was such an issue. This issue is bottomed upon the fiduciary obligation of the respondent as a dominant and controlling stockholder, director, officer, owner of one-third of the capital stock and a very substantial claim for contribution, to contract such debts, knowing when he did so that the claims of such creditors would not be paid in full, especially if he were to compete with them for the payment of his claim for contribution.

The only instances in which it might be remotely claimed that the Appellate Court considered such issue are as follows: In its opinion (R. 83), it said: "At the end of 1937 the bankrupt owed creditors, other than Budge, $4,913.15." However, the Court does not indicate that it knew all of that indebtedness had been contracted after July 1, 1937, which was the fact (R. 43), or if it were that such date had any significance. The Appellate Court says (R. 85), that the referee found that Budge had acted in good faith and that his acts and conduct should not be considered even constructively fraudulent as to other creditors. What the Court refers to appears in the referee's summary of the evidence in his certificate attached to the record on review before the District Court. The referee said there was no bad faith or fraud in connection with Budge's account with the corporation or the advances he made to the corporation (R. 57). The referee said nothing about creditors whose debts were contracted after July 1, 1937, and naturally he would not because in his Finding of Fact IX (R. 46) sup-

porting his order allowing the claim he found that the corporation used the money. Hence, he allowed the claim. The District Court did not consider the issue. The quotation from that Court's order (R. 85) speaks of the money being contributed in good faith to the corporation. The District Court said there was no such fraud as in *Pepper vs. Litton, supra.* The Appellate Court (R. 87) says: "The advances were made before the creditors to whose claims it is now contended Budge's claim should be subordinated, had become creditors." The Court clearly had in mind something that respondent had done before the debts were contracted, not his conduct or obligation in contracting the debts after July 1, 1937. That this petitioner urged this issue in the Appellate Court is apparent from the petition for rehearing (R. 94).

3.

It Is Not Discretionary With a Bankruptcy Court as to Whether or Not a Claim Shall Be Subordinated Where the Facts Are Undisputed and to Fail to Subordinate Such Claim Would Be Unfair or Inequitable as to Other Creditors.

We respectfully submit with all due respect for the opinion of the Appellate Court, that its failure to subordinate respondent's claim was erroneous. The Court apparently considered it was discretionary with the District Court as to whether respondent's claim should be subordinated to that of other creditors. The Appellate Court conceded that the lower court could have subordinated the claim on a finding that respondent's informal and irregular conduct of the affairs of the bankrupt had prejudiced creditors' rights and was a violation of respondent's duty to the creditors. There being no disputed question of fact, the failure of the Dis-

trict Court to make a finding did not prevent the Appellate Court from reversing the lower court and requiring it to subordinate respondent's claim.

Quinn vs. National Bank (C. C. A. 8), 32 F. (2d) 762, 763.

In fact, discretion does not extend to a refusal to apply well settled principles of law to a conceded or indisputable state of facts.

Peterson vs. John Hancock Mut. Life Ins. Co. (C. C. A. 8), 116 F. (2d) 148.

The motion for rehearing of the order of the District Court affirming the allowance of respondent's claim called for a judicial decision and not the exercise of any discretion since the facts were not in dispute.

Peterson vs. John Hancock Mut. Life Ins. Co., supra.

Respectfully submitted,

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